STATE OF DELAWARE
PUBLIC SERVICE COMMISSION
861 SILVER LAKE BOULEVARD
CANNON BUILDING, SUITE 100
DOVER, DELAWARE 19904

TELEPHONE: (302) 736-7500
FAX: (302) 739-4849

January 7, 2010

Bruce H. Burcat, Executive Director
Delaware Public Service Commission
861 Silver Lake Boulevard
Cannon Building, Suite 100
Dover, DE 19904

RE: PSC Docket No. 08-269F; Phase II

Dear Mr. Burcat:

Pursuant to Commission Order No. 7607 (July 7, 2009), I have conducted hearings in the captioned docket and submit herewith the following:

1) An original of my Findings and Recommendations of the Hearing Examiner for the Commission's consideration.

2) An Exhibit Log, identifying Exhibits 20 through 24, which form part of the evidentiary record.

A current service list for this docket is also attached for your information.

Very truly yours,

Mark Lawrence,
Hearing Examiner

Attachments (as stated)

BEFORE THE PUBLIC SERVICE COMMISSION

OF THE STATE OF DELAWARE

IN THE MATTER OF THE APPLICATION OF CHESAPEAKE UTILITIES CORPORATION FOR APPROVAL OF A CHANGE IN ITS GAS SALES SERVICE RATES ("GSR") TO BE EFFECTIVE NOVEMBER 1, 2008 (FILED SEPTEMBER 2, 2008 AND AMENDED JANUARY 8, 2009)	)	PSC DOCKET NO.08-269F PHASE II

FINDINGS AND RECOMMENDATIONS OF THE HEARING EXAMINER

DATED: January 7, 2010

MARK LAWRENCE
HEARING EXAMINER

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FINDINGS AND RECOMMENDATIONS OF THE HEARING EXAMINER

Mark Lawrence, duly appointed Hearing Examiner in this Docket pursuant to PSC Order No. 7446 dated September 16, 2008, reports to the Commission as follows:

I. APPEARANCES

On behalf of the Applicant, Chesapeake Utilities Corporation Delaware Division ("Chesapeake" or "Company"):

Parkowski, Guerke & Swayze, P.A.,
BY: WILLIAM A. DENMAN, ESQUIRE
Jennifer A. Clausius, Manager of Pricing & Regulation

On behalf of the Public Service Commission Staff ("Staff"):

BY: REGINA IORRI, ESQUIRE, Deputy Attorney General
Susan Neidig, Regulatory Policy Administrator
Richard W. LeLash, Staff Consultant

On behalf of the Division of the Public Advocate ("DPA"):

G. ARTHUR PADMORE, PUBLIC ADVOCATE
MICHAEL SHEEHY, DEPUTY DIRECTOR, PUBLIC ADVOCATE
KENT WALKER, ESQUIRE, DEPUTY ATTORNEY GENERAL
Andrea C. Crane, The Columbia Group, DPA Consultant

II. BACKGROUND

A. INTRODUCTION

1. The issue in Phase II of this Docket is whether, as Staff and DPA argue, Chesapeake's Delaware Division's practice of charging Delaware ratepayers $.5915/DTH for natural gas when its unregulated subsidiary PESCO pays Chesapeake only $.17/DTH for the same gas is unreasonable, preferential and violates asymmetrical pricing principles, which would require that Delaware ratepayers be charged no more than the actual cost of the gas. Chesapeake purchases capacity release rights for gas from its transmission subsidiary, Eastern Shore Natural Gas ("ESNG") for $.5915/DTH. Chesapeake charges its Delaware ratepayers the $.5915/DTH cost. ESNG releases the gas to PESCO so that PESCO can sell the gas to off-system customers. PESCO pays Chesapeake $.17/DTH for the gas released by ESNG. Thus, Delaware ratepayers are paying $.5915/DTH for gas while PESCO is paying $.17/DTH. Before addressing this issue, however, some background is necessary.

B. GSR PROCEEDING

2. On September 2, 2008, Chesapeake filed its annual Application with the Commission seeking approval to decrease its Gas Sales Service Rates ("GSR") for all customer service classes effective November 1, 2008. By Order No. 7446 dated September 16, 2008, the Commission permitted the proposed rate changes to go into effect on November 1, 2008, on a temporary basis, subject to refund pending full evidentiary hearings. The Commission also designated this Hearing Examiner to conduct the hearings and report to the Commission his proposed Findings and Recommendations. I established a Procedural Schedule and scheduled an evidentiary hearing for May 28, 2009. The Public Advocate filed a statutory notice of intervention in this Docket on September 24, 2008.

3. On January 8, 2009, Chesapeake filed a Supplemental Application seeking Commission approval of an additional decrease to the GSR rates which were approved by PSC Order No. 7446 because the projected under-collection exceeded the 6% threshold contained in the Chesapeake's Tariff Sheet No. 42. The Company also sought a waiver of the sixty (60) day notice requirement of 26 *Del. C.* § 304(a) to allow the new rates to become effective with bills rendered on or after February 1, 2009. The Commission granted the requested waiver by Order No. 7521 dated January 29, 2009, on a temporary basis subject to true-up and refund pending full evidentiary hearings.

C. EVIDENTIARY HEARING IN THE GSR PROCEEDING

4. On May 28, 2009, the parties requested that I reschedule the evidentiary hearing to allow the parties to continue to pursue settlement negotiations. I rescheduled the evidentiary hearing for June 11, 2009. At the evidentiary hearing, the parties submitted a proposed Settlement Agreement resolving all contested issues except the following stated issue which would be addressed in Phase II:

> "Whether the Company is providing pipeline capacity to its affiliate PESCO on terms and conditions consistent with applicable law, rules, and/or regulations (that is, whether, and if so, to what extent, asymmetric pricing principles apply for pipeline capacity released to PESCO to serve the Company's former off-system sales ("OSS") customers, and whether asymmetric pricing principles should apply in determining the amount of the credit to the GSR for pipeline capacity released to PESCO?"

5. Staff and the DPA argue that the capacity releases requested by Chesapeake's Delaware Division from Chesapeake's affiliate Eastern Shore Natural Gas (ESNG) for release to Chesapeake's affiliate PESCO for sale to PESCO's off-system customers are subject to the parties' 2001 Settlement Agreement

and the Commission's Order in PSC Docket No. 00-523[1]. That Order required Chesapeake to use "asymmetric pricing principles" in transactions with affiliates. In this Docket, Staff and DPA maintain that asymmetric pricing principles require that Chesapeake's Delaware Division must charge Delaware ratepayers the same cost paid by PESCO to Chesapeake's Delaware Division for gas releases from Eastern Shore. (Crane (DPA), Ex. 22, p.19 LL 19-21, P.20 LL 1-9; LeLash (PSC), Ex. 23A, p.9, LL 5-12.) As will be described later herein, Chesapeake principally argues that the parties Settlement Agreement and the Commission's Order in PSC Docket No. 07-246F supersedes PSC Docket No. 00-523.

D. COMMISSION ORDERS PHASE II OF THIS DOCKET

6. The Commission approved the parties' proposed Settlement Agreement in Order No. 7607 (July 7, 2009) thereby approving Chesapeake's Gas Sales Service Rates ("GSR") for service rendered on after November 1, 2008. The Commission further authorized Phase II of this proceeding to consider the above issue regarding Chesapeake's pricing policies regarding its affiliate PESCO.

E. PHASE II: DISCOVERY & BRIEFING

7. The parties proposed a Procedural Schedule for Phase II, which the Hearing Examiner subsequently approved. (T-85-87) Pursuant to the Agreed Procedural Schedule for Phase II, the Company filed the pre-filed direct testimony of Jennifer A. Clausius, its Manager of Pricing and Regulation on June 29, 2009. (Ex. 21.) On August 4, 2009, the Public Advocate filed pre-filed testimony from its expert, Andrea C. Crane, President of The Columbia Group, Inc.[2] (Ex. 22) On that same date, Staff filed direct testimony from its expert Richard W. LeLash. (Ex. 23A.) On August 18, 2009, the Company filed rebuttal testimony from Ms.

[1] PSC Docket 00-523 was denominated as *IN THE MATTER OF THE APPLICATION OF CHESAPEAKE UTILITIES CORPORATION FOR APPROVAL OF A COST ACCOUNTING MANUAL AND A CODE OF CONDUCT* (Opened September 22, 2000)

[2] Each of these witnesses also submitted pre-filed testimony in Phase I of this Docket.

Clausius. (Ex. 24.) I conducted a pre-hearing conference with the parties on August 26, 2009. During this pre-hearing conference, the parties advised they would prefer to submit the issue on briefs and that the parties would not conduct any cross-examination at the evidentiary hearing.

8. On August 26, 2009, Staff filed a Motion to Strike certain portions of the direct and rebuttal testimony of Chesapeake's witness, Jennifer Clausius. The Company filed its response on August 28, 2009. Thereafter, Staff and the Company reached an agreement on striking portions of Ms. Clausius' testimony. On September 2, 2009, the Hearing Examiner entered an Agreed Order striking portions of Ms. Clausius' testimony.

9. On September 2, 2009, I conducted an evidentiary hearing. Chesapeake made minor corrections to Ms. Clausius' rebuttal testimony. In addition, the parties' pre-filed testimonies were admitted into evidence. After the close of the record, the parties and the Hearing Examiner jointly established a briefing schedule.[3] Pursuant to that briefing schedule, the Company filed its opening brief on September 23, 2009. On October 14, 2009, Staff and the Public Advocate filed their respective Answering Briefs. On October 26, 2009, the Company filed its Reply Brief.

10. The record, as developed at the evidentiary hearing, consists of a verbatim transcript of twelve (12) pages and six (6) exhibits. I have considered all of the record evidence,[4] and the briefs of the parties. Based thereon, I submit for the Commission's consideration these Findings and Recommendations.

[3] Regarding the Phase II Evidentiary Hearing, the Affidavits of Publication of notice from the Delaware State News and The News Journal newspapers are included in the record as composite Exhibit 2. In this Report, Exhibits will be cited as "Ex.__" and references to the hearing transcript will be cited as "Tr.__."

[4] The parties agreed that the six (6) exhibits introduced at the evidentiary hearing and transcript were part of the evidentiary record. Also, the parties agreed that all discovery propounded in Phase II and the responses thereto were not part of the evidentiary record. (*Tr. 117, 122*)

III. SUMMARY OF THE EVIDENCE

A. CHESAPEAKE UTILITY CORPORATION'S DIRECT TESTIMONY

11. On June 29, 2009, the Company filed the pre-filed testimony of Jennifer Clausius, its Manager of Pricing and Regulation. Ms. Clausius testified that: "The purpose of my direct testimony is to provide relevant background information and support the Company's position regarding temporary releases of interstate pipeline transportation capacity by Chesapeake's Delaware Division pursuant to the regulations of the Federal Energy Regulatory Commission ("FERC"), and to specifically address the issues in Phase II relating to the temporary releases of such capacity to Chesapeake's affiliate, Peninsula Energy Services Company, Inc."("PESCO") (Ex. 21, p. 4, LL 6-14) The Federal Energy Regulatory Commission, or FERC, is an independent federal agency which regulates the wholesale sales of electricity and the interstate transmission of natural gas, oil and electricity. FERC also authorizes construction of natural gas pipelines and hydro power projects and oversees the reliability of the Bulk-Power System.

12. Ms. Clausius summarized the Company's position as follows:

A. Since January, 2008, Chesapeake's Delaware Division's interstate pipeline capacity releases to its former off-system sales customers have benefitted its firm customers by reducing costs.

B. The Delaware Division's interstate pipeline capacity releases have been performed in accordance with the federal government's regulations regarding interstate pipeline capacity releases.

C. Other than Chesapeake's Delaware and Maryland Divisions, no other entity has released interstate pipeline capacity on Eastern Shore greater than or equal to $0.17 per Dt capacity release rate.

D. Chesapeake's Delaware Division's interstate pipeline capacity release rate "has been supported by the open bidding process for these former off-system sales customers."

E. Chesapeake's Delaware Division's interstate pipeline capacity releases are not subject to the Settlement Agreement in PSC Docket No. 00-523 or alternatively the interstate pipeline capacity releases from Chesapeake's Delaware Division to PESCO are not subject to asymmetric pricing principles. This is because "the terms of the interstate pipeline capacity and the temporary rights to the capacity that Chesapeake's Delaware Division releases to PESCO are not the same capacity terms and permanent rights by which Chesapeake acquired the capacity from Eastern Shore. The rights that PESCO has as a temporary replacement holder of the firm transportation capacity on Eastern Shore are not the same as the rights that Chesapeake has as the permanent holder of the capacity." (Ex. 21, p. 5, LL 4-23 & p. 6, LL 1-12.)

13. According to Ms. Clausius, in PSC Docket No. 07-246F,[5] the Company's GSR case which preceded this Docket, the Company informed the Commission in its Application that it was the Company's intent to no longer be engaged in the business of making off-system sales. (Ex. 21, p. 7, LL 1-2) An off-system sale is "the sale of natural gas by a utility to a customer who is not directly connected to the utility's distribution system." (*Id.* at p.7 LL 2-5) The Company contractually assigned eleven (11) former off-system sales customers to a marketing affiliate, PESCO, and began releasing Delaware Division capacity on Eastern Shore's pipeline to enable PESCO to serve these customers. (*Id.*

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[5] As will be described later herein, Staff and the DPA argue that the capacity releases by Chesapeake's Delaware Division to PESCO are subject to the parties' Settlement Agreement and the Commission's Order in PSC Docket No. 00-523, which required Chesapeake to use "asymmetric pricing principles." Asymmetric pricing principles require that transfers from Chesapeake's Delaware Division to an affiliate are at the higher of fully allocated cost or market price, and transfers from an affiliate to Chesapeake's Delaware Division are at the lower of fully allocated cost or market price. (Ex. 21, p. 21, LL 17-23, p. 22 L 1)

at p.7 LL 5-11)

14. Prior to PSC Docket No. 07-246F, margins earned from off-system sales by Chesapeake's Delaware Division were shared with Delaware customers in the form of a credit in Chesapeake's annual GSR Applications. In other words, these shared margins reduced the Delaware customers' cost of gas. (*Id.* at p. 7 LL 11-12) On average, the Company shared approximately 41% of these margins based on the margin sharing mechanism in effect at the time. After the end of off-system sales by Chesapeake's Delaware Division, the company began crediting the GSR with 100% of the capacity release amounts credited to Chesapeake's account by Eastern Shore as a result of the capacity releases to PESCO. (*Id.* at p.7 LL 14-18) According to the Company, the intent of this credit was so that the Delaware Division's customers would receive a reduction in gas costs similar to what had been received when the Delaware Division was making off-system sales." (Ex. 21, p.7, LL 18-21.)

15. Ms. Clausius testified that the settlement in PSC Docket No. 07-246F provided as follows:

> "…it (Chesapeake) will credit the GSR, on an on-going basis, for 100% of the revenues received by the Company for any capacity release to serve former off-system sales customers. The credit will be designed to equate to what would have been credited through the margin sharing mechanism had these off-system sales customers remained off-system sales customers of the Company. The parties acknowledge that the amount of the credit may fluctuate in the event of a reduction in load of a particular customer or a particular customer no longer needs capacity." (Ex. 21, p. 8, LL 3-15 and 2008 Settlement Agreement, Para. 11, PSC Order No. 7607)

16. Ms. Clausius testified that in this Docket that, in Docket No. 07-246F, the Company "informed the parties that the five-year average of off-system sales margins credited to the firm customers totaled approximately $160,000 per year." (Ex. 21, p.8 LL 19-22) According to Ms. Clausius, the Company also informed the parties "during settlement discussions that the

Company would release capacity to PESCO at a rate that was intended, but not guaranteed, to produce a GSR credit for capacity release revenue of $160,000 per year. (*Id.* at LL 22-25) Further, in the event that capacity release revenue exceeded $160,000 in any year, the Company would credit the firm sales customers with 100% of the entire amount received as a result of capacity releases." (Ex. 21, p.8, LL 19-28) For the twelve (12) month period ending December 2008, the total actual GSR credit to customers from capacity released to PESCO on a month-to-month basis was $198,880; for the five (5) month period ending May 2009, the total GSR credit resulting from such capacity releases was $189,343. (Ex. 21, p.13, LL 10-13)

17. Ms. Clausius testified that, in the open market, these off-system sales customers can purchase natural gas from any qualified third party, normally a marketer. Although there are several marketers located on the Delmarva Peninsula which compete for this business, most former Delaware Division off-system sales customers are presently being served by PESCO. There is one former off-system sales customer being supplied by a marketer which is not affiliated with Chesapeake. (Ex. 21, p.9, LL 12-20) Chesapeake's Delaware Division has been releasing capacity to that marketer at the same $0.17 per Dt rate. (Ex. 21, p. 16, LL 9-11) As a general rule, if they do not obtain capacity directly, marketers must obtain capacity elsewhere on interstate pipelines so natural gas can be transported to the off-system sales customers. (Ex. 21, p.10, LL 1-4)

18. After PSC Docket No. 07-246F concluded, Ms. Clausius testified that the Company's "initial resulting capacity release rate was $0.17 per dekatherm ("Dt") for capacity released to PESCO for these customers. This initial capacity release rate was the result of dividing the average annual GSR credit of $160,000 from these off-system sales by the number of Dts of released capacity that the Company estimated would be required to serve the off-system sales customers on an annual basis." (Ex. 21, p.9, LL 1-8)

19. Ms. Clausius testified that, in order to ensure that it has the ability to provide its firm customers with natural gas service, Chesapeake's Delaware Division generally enters into long-term transportation capacity agreements with interstate transmission pipelines. (Ex. 21, p.10, L 15-19) These capacity agreements ensure the Company has reserved adequate space on the interstate pipeline to transport the natural gas required to serve its firm customers on a design day. These agreements are often entered into "up to three or four years" in advance. (Clausius' Rebuttal, Ex. 24, p. 9, LL 21-22, p. 10, LL 1-2) A design day for Chesapeake's Delaware Division is a 24-hour day where the average temperature is five degrees Fahrenheit (5°F). The Delaware Division's firm customers, through the GSR, pay for the cost of this capacity. (Ex. 21, pp 10-11.)

20. On days when the Delaware Division's design day pipeline capacity is not needed to serve its customers, the Delaware Division has the ability to offer this capacity temporarily to other shippers who may be interested in acquiring such capacity on a temporary basis. A shipper is a party who has been approved by the interstate pipeline to transport natural gas on such interstate pipeline. Any marketer, including PESCO, who acts as a shipper, may have an interest in such capacity. End-users of natural gas, such as the Company's former off-system sales customers, might also be interested in obtaining such capacity for their own use. (Ex. 21, p.11, LL 1-15)

21. From January 1, 2008 through July 1, 2009, there were two (2) capacity release entries by other parties and both capacity releases were made at $0.08 per Dt, less than the $0.17 per Dt rate for the capacity released to PESCO by Chesapeake's Delaware Division. (Ex. 21, p.11, LL 19-23; p. 12, LL 1-3; *See* JAC Attachment JAC-1)

22. The Delaware Division designates all of the capacity it releases as partially or fully recallable when needed to serve its own firm customers who have the first rights to this capacity if required. Capacity which is recallable by the releasing

shipper has less value to replacement shippers or marketers than capacity which is not recallable. Marketers willing to accept capacity which is recallable will typically bid less than the maximum tariff rate. Once the capacity is released to the marketer, the pipeline bills the marketer directly for the capacity at the rate determined acceptable between the marketer and the releasing party through the bidding process. The pipeline credits the releasing party the amounts paid directly by the marketer. (Ex. 21, pp.12-13)

23. Chesapeake's Delaware Division has been releasing capacity to PESCO from month-to-month. Ms. Clausius asserted that FERC's rules provide that a firm capacity holder, such as the Delaware Division, may not roll over, extend, or in any way continue such month-to-month releases to the same replacement shipper until 28 days after the first release of 31 days or less has ended. (Ex. 21, p.13, LL 17-22) This 28-day hiatus rule does not apply to any re-release to the same replacement shipper if the proposed re-release is posted for bidding. In order to comply with this rule, the Company posts the $0.17 per Dt rate on Eastern Shore's electronic bulletin board, which enables other parties to submit competing bids for that capacity. Under FERC's rules, any pre-designated shipper would have the right to receive all of the capacity covered by the prearranged release agreement if, and only if, that party met the highest competing bid. From month-to-month, the $0.17 per Dt rate bid by PESCO for this capacity has been the only bid submitted. No other party has submitted a higher bid. Therefore, according to Ms. Clausius, "the open bidding process has provided evidence that supports the $0.17 per Dt rate." (Ex. 21, p.14, LL 1-10)

24. According to Ms. Clausius, PESCO is not the only marketer doing business in Delaware which would be interested in serving these customers. One of the former off-system sales customers which Chesapeake's Delaware Division served is currently being served by a marketer not affiliated with Chesapeake. It is possible that another marketer which could get

capacity at a rate lower than the maximum rate would be able to provide a lower cost alternative to the customers to obtain their business. Second, these off-system sales customers have an alternative fuel source other than natural gas. They would only choose to burn natural gas if it was economical, as compared to the alternative fuel. If these customers were required to pay the maximum rate for capacity, it may make natural gas more expensive as compared to the alternative. Finally, PESCO could enter into a business arrangement with any other holder of Eastern Shore capacity for a release of capacity to PESCO at a rate lower than the maximum rate, thereby increasing costs to Chesapeake's Delaware Division form customers. (Ex. 21, p.16, LL 11-22)

25. Ms. Clausius testified that all payments received by Eastern Shore from PESCO for capacity releases to PESCO are credited to the Delaware Division by Eastern Shore. (Ex. 21, p. 17, LL 1-3) The entire amount of this credit is flowed through 100% to the Delaware Division's ratepayers. To the extent that this credit is substantially reduced or even eliminated, the Delaware Division's ratepayers will experience an increase in costs.

B. <u>PUBLIC SERVICE COMMISSION'S STAFF TESTIMONY</u>

26. On August 4, 2009, Staff filed the pre-filed testimony of its expert Richard W. LeLash. Mr. LeLash's recommendations were as follows:

A. The Company should cease releasing capacity to PESCO at any rate less than the $0.59 per Dth cost of the capacity.

B. Alternatively, if the Company continues to make such capacity releases to PESCO at rates which are less than cost, the Commission should order the Company to provide credits to its GSR charges to reflect the difference between the release rate and the cost rate of $0.59 per Dth (or whatever cost the Company pays to ESNG in the future). In this way, the Company can continue to supply PESCO, but its shareholders, rather than its ratepayers, would pay for any subsidy resulting from the discounts to the capacity's actual cost. (Ex. 23A, p.9, LL 5-12)

27. Mr. LeLash's analysis began by describing Staff's problems with Chesapeake's practice: "In the most recent GSR review, the Company disclosed that it was providing the capacity releases to PESCO at a rate of $0.17 per Dth while the cost of the associated capacity was $0.59 per Dth. As a result, during the period of January 2008 through May 2009, the Company received $388,223 from PESCO for the releases while paying Eastern Shore Natural Gas ("ESNG") charges for the capacity totaling $1,305,788." (Ex. 23A, p.2, LL 20-21, p. 3, LL 1-5)

28. Mr. LeLash focused on the parties' Settlement Agreement in PSC Docket 00-523. Regarding PSC Order No. 5828 entered in Docket 00-523, Mr. LeLash testified that the Commission approved a Code of Conduct ("Code") for the Company. Mr. LeLash testified that "[i]n the Settlement Agreement which the Commission approved in PSC Order No. 5828 [November 6, 2001], the Company agreed that asymmetrical pricing principles would govern transactions between it and its non-regulated affiliates."[6] (Ex. 23A, p.3, LL 8-12; Paragraph II (10) of 2001 Settlement Agreement)

29. Mr. LeLash testified that, according to the Settlement Agreement, "for transfers from Chesapeake to the Affiliate, the higher of fully allocated cost or market price; for transfers from the Affiliate to Chesapeake, the lower of the fully allocated cost or market price shall apply." (*Id.* at p.3, LL 13-15.) Mr. LeLash concluded that "the Company's sales of capacity

[6] Paragraph II(10) of the Settlement Agreement in PSC Docket 00-523 provides as follows: "The Settling Parties agree that subject to the provisions set forth below, for transfer of assets between Regulated Activities ("Chesapeake") and Non-Regulated Activities, ("Affiliate") asymmetric pricing principles (i.e. for transfers from Chesapeake to the Affiliate, the higher of fully allocated cost or market price; for transfers from the Affiliate to Chesapeake, the lower of fully allocated cost or market price) shall apply. Asymmetric pricing principles shall also apply to the provision of services, exclusive of shared services or common support services, provided however that if the market price of such service is not reasonably ascertainable, fully allocated costs will be used."

to PESCO at less than the cost violates the terms of the settlement signed by the Company and approved by the Commission." (*Id.* at p.4 LL 6-8.)

30. Regarding the market price for its capacity, Mr. LeLash testified that "the Company derived a $0.17 per Dth rate for capacity releases for former customers based on the five-year average of the sales margins credited to the firm customers." (Ex. 23A, p.4, LL 14-19) The per Dth rate "was the result of dividing the average annual GSR credit of $160,000 from the off-system sales customers by the number of Dts of released capacity that the Company estimated would be required to serve these customers on an annual basis." Mr. LeLash testified that the Company provided data attempting to support this estimate.[7] However, Mr. LeLash testified that the data "does not appear to use five year margin or volume amounts." (Ex. 23A, p.4, LL 20-21) Mr. LeLash testified that, "based on the data supplied and the Company's responses …, it appears that the variations may be reflecting a mismatch in the data. Prior to its transfer of the off-system sales customers to PESCO, the Company was providing both capacity and commodity gas to the transferred customers; therefore, differences in rates might involve the margin on the commodity sales since the Company, after the transfer, is only providing capacity releases without any associated gas supply." In other words, there may be a mismatch of capacity versus off-system margins.

31. Paragraph II(10) entitled "Pricing Principles" provides as follows:

> Pricing Principles. The Settling Parties agree that subject to the provisions set forth below, for transfer of assets between Regulated Activities ("Chesapeake") and Non-Regulated Activities, ("Affiliate") asymmetric pricing principles (i.e. for

[7] Again, the parties' discovery responses are not part of the evidentiary record. *See* Footnote 3, *supra*.

transfers from Chesapeake to the Affiliate, the higher of fully allocated cost or market price; for transfers from the Affiliate to Chesapeake, the lower of fully allocated cost or market price) shall apply. Asymmetric pricing principles shall also apply to the provision of services, exclusive of shared services or common support services, provided however that if the market price of such service is not reasonably ascertainable, fully allocated costs will be used.

32. Mr. LeLash also testified about the Company's "market rates." (Ex. 23A, p.5, LL 5-21) The Company makes two types of capacity releases. Its "reservation capacity releases" require the replacement shipper to pay the awarded rate for the full capacity regardless of actual utilization. For the Company's commodity or volumetric capacity releases, the replacement shipper pays the awarded rate only for the volumes actually utilized. Thus, Mr. LeLash opined that there are two rates typically being charged by the Company, the $0.17 per Dth rate for volumetric releases and the $0.59 per Dth rate for reservation releases.

33. According to Mr. LeLash, the $0.17 per Dth volumetric rate does not represent a market rate, but rather is an arbitrary credit amount that was chosen by the Company and not actually negotiated with PESCO. (Ex. 23A, p.5, LL 20-21) When the Company makes its capacity release offers, it specifies a maximum rate of $0.59 per Dth and a minimum rate of $0.17 per Dth for Zone 2 capacity. According to Mr. LeLash,, when PESCO contracts for such capacity, it bids the $0.17 minimum rate and the Company has never requested PESCO to pay more than the minimum rate. Mr. LeLash believes that PESCO may pay more than $0.17 per Dth. According to Mr. LeLash, "the Company has stated that ESNG has no excess firm capacity available and that capacity resources are

tight." Thus, Mr. LeLash opined that "the true market price may well be above the $0.17 per Dth level."(Ex. 23A, p.5, LL 20-21, p.6, LL 1-14)

34. According to Mr. LeLash, one of the major differences arises because the Company makes all of its capacity releases, both reservation and volumetric, subject to recall. (Ex. 23A, p. 6, LL 19-21) Thus, while the Company could limit its recall equipment to releases in the winter when it may be needed to serve its firm customers, it does not choose to do so. This is so even though Company stated that it did not recall any capacity releases during the past 18 months and could not remember when it had ever recalled capacity prior to that period. (Ex. 23A, p.7, LL 2-4)

35. According to Mr. LeLash, the Company has design day deliverability which substantially exceeds the Company's forecasted firm demand requirements for 2008-09. By comparison, the customers transferred to PESCO had average daily demand of about 4,500 Mcf per day with their peak usage occurring during the June to August period of each year. Thus, in Lelash's opinion, the Company does not need to make all of its releases subject to recall. (Ex. 23A, p.7, LL 8-13)

36. Mr. LeLash was not persuaded by the Company's argument that if the Company's practice with PESCO ceased, Delaware ratepayers would lose capacity credits of approximately $160,000 per year. LeLash opined that the Company could save the Delaware ratepayers substantially more by shedding excess capacity. (Ex. 23A, p.7, LL 17-21) LeLash opined that, through 2011, the Company has excess capacity reserves. Assuming a reserve of 5% and reducing capacity accordingly, the savings would be $4,700 per day, or $1.7 million on an annual basis. Therefore, according to LeLash, "a reduction in a portion of the Company's excess capacity would yield about $1.6 million more in annual savings than the Company makes on its capacity releases to PESCO." (Ex. 23A, p.8, LL 1-4)

37. Finally, Mr. LeLash addressed the Company's plans on receiving 7,730 Dts of daily incremental ESNG capacity. Mr. LeLash argues that, if that additional capacity could be delayed or taken on a deferred basis, material savings could be realized. The Company disclosed that it was currently deferring some of its existing capacity commitments with ESNG and presumably this will also be possible prospectively. (Ex. 23A, p. 8, LL 7-11) Mr. Lelash contended that the examples of financial impact of capacity releases to PESCO and the potential of excess deliverability of capacity from ESNG highlight the need for and the rationale of the Code of Conduct established in PSC Docket 00-523. Mr. LeLash argued that setting capacity at below cost rates forces ratepayers to subsidize the unregulated business of the Company's affiliate, PESCO. Further, Mr. LeLash opined that committing to excess pipeline deliverability from ESNG also creates an artificial subsidy from regulated ratepayers to its other affiliate ESNG. (Ex. 23A, p.8, LL 12-17)

C. DIVISION OF PUBLIC ADVOCATE'S TESTIMONY

38. On August 4, 2009, the DPA filed the pre-filed testimony of its expert Andrea C. Crane, President of The Columbia Group. Ms. Crane first addressed whether the asymmetric pricing principles required by the Settlement Agreement in Docket 00-523 applied to the releases by Eastern Shore to PESCO for off-line sales. Ms. Crane's testimony sums up the DPA's position:

> "Yes, in my opinion, there is no doubt whatsoever that these releases fall within the requirements of the Settlement Agreement. On pages 22-23 of her Direct Testimony, Ms. Clausius explains that she does not believe that the Settlement Agreement in Docket No. 00-523 applies because the release of capacity is not the transfer of an asset or the provision of a service. The asymmetric pricing principles in the Settlement Agreement were designed to cover both transfers of balance sheet items, i.e., assets, as well as transfers impacting the income settlement, i.e., services. If [Chesapeake] is

not selling either an asset or a service, then what are they being paid for by PESCO? There is obviously some item of value being transferred."

"Since capacity costs are generally expensed by a utility, I would consider the provision of capacity to be a service in this case. In fact, Ms. Clausius acknowledges on page 24 of her testimony that "PESCO is receiving transportation service."[8] Ms. Clausius goes on to state that the transportation service being provided by Eastern Shore, not by [Chesapeake], and is governed by the terms and conditions of ESNG's FERC Gas Tariff."

"While [Chesapeake] is not directly providing transportation service to PESCO, it is providing the right to receive that transportation service, which is purchased from ESNG. PESCO is receiving a service from [Chesapeake]. Whether one characterizes that service as transportation service or as the right to receive transportation service from ESNG, a service is being provided by [Chesapeake] to PESCO as a result of the capacity release transaction."

"Ms. Clausius' next argument is that even if the Settlement Agreement does not apply to this transaction, asymmetric pricing principles should not apply. This time her argument is based on the contention that the interstate pipeline capacity being sold to PESCO is different from the interstate pipeline capacity being purchased from ESNG, because the former is recallable while the latter is firm. Accordingly, Ms. Clausius concludes on page 25 of her Direct Testimony that asymmetric pricing should not apply because "[i]t is impossible to determine what the actual "cost" of the released capacity would be since it is recallable by the utility under different terms and conditions."

"Even if one assumes that the capacity being sold to PESCO is different from the capacity being purchased by [Chesapeake], it does not follow that asymmetric pricing principles

[8] Ms. Clausius testified as follows:"[i]n capacity release transactions, PESCO is receiving transportation service; however, PESCO receives this service from Eastern Shore, not Chesapeake's Delaware Division, and the service is provided subject to the terms and conditions of Eastern Shore's FERC Gas Tariff." (Ex. 21, p. 24, LL 1-5)

should be abandoned. The pricing principles clearly state that affiliated transactions should be priced at the higher of cost or market."

"The purpose of asymmetric pricing principles is to ensure that ratepayers do not subsidize unregulated activities. If the actual cost from ESNG is not used in the asymmetric pricing formula then ratepayers will clearly be subsidizing the Company's unregulated activities. As noted earlier, ratepayers are currently paying $0.5915 per Dth for capacity sold to PESCO, with PESCO paying only $0.17 per Dth of the overall cost. Thus, ratepayers are providing a subsidy to PESCO of $0.4215 per Dth. If this situation is not corrected, this cross-subsidization will continue in violation of both the letter and the spirit of the Settlement Agreement in PSC Docket No. 00-523." (Crane, Ex. 22, p. 12-L7-21, p. 13 L1-6, L 17-20, p. 14-L 1-8, 13-20-emphasis supp.)

39. Ms. Crane addressed Ms. Clausius' claims that "[b]esides Chesapeake's Delaware and Maryland Divisions, no other entity has released interstate pipeline capacity on Eastern Shore greater than or equal to the $0.17 per Dth capacity release rate." (Ex. 22, p.16, LL 3-7) Ms. Crane stated that Ms. Clausius failed to state that the Maryland Division releases were significantly above $0.17 per Dth, and in fact, were at the cost rate of $0.5915 per Dth. According to Ms. Crane, since the asymmetric pricing principles require that affiliated transactions be priced at the higher of cost or market price, the market price only becomes relevant if it is above cost. No party has claimed in this case that market price is higher than cost. Therefore, there is no need for the PSC to determine what the appropriate market price is for the ESNG capacity. (Ex. 22, p. 16, LL 13-17)

40. According to Ms. Crane, Ms. Clausius states that the "Delaware Division's interstate pipeline capacity release rate has been supported by the open bidding process for these former off-system sales customers," suggesting that the price is a market price. However, this is relevant only if the market price

was above cost, which it is not. It should also be noted that the initial rate for the capacity sold to PESCO was not determined through a competitive bidding process, but rather was a calculated rate designed to produce a target level of revenue. Moreover, even if the rate of $0.17 per Dth had been the result of a competitive bidding process, the Settlement Agreement would still require this capacity be transferred to PESCO at cost. Thus, whether the rate of $0.17 per Dth is a market rate or not is immaterial, and only becomes relevant if the market rate were to exceed $0.5915 per Dth. (Ex. 22, p.16, LL 18-21, p.17, LL 1-6)

41. Addressing the issue of whether these sales have benefitted ratepayers, Ms. Crane testified that "[w]hile it is true that these capacity release revenues provided some margin credits to the GSR, it is not clear that the ESNG capacity has provided a net benefit to retail ratepayers. As I have testified in the last several GSR proceedings, Chesapeake has pursued aggressive expansion in eastern Sussex County and has increased its ESNG capacity in each of the past several years, at least in part to serve future projected expansion. Chesapeake is able to sell some of its ESNG capacity to PESCO because it has more than it needs to serve more than it needs to serve its own customers. Therefore, in spite of the fact that ratepayers are receiving a small credit from the sale of capacity to PESCO, it is just as likely that they have paid costs for capacity that was not needed to serve existing customers."(Ex. 22, p.17, LL 16-21, p.18, LL 1-3)

42. Ms. Crane testified that "[a]s stated in my Direct Testimony in Phase I of this case,

> The issue of expansion in eastern Sussex County is closely aligned with the extension of ESNG's pipeline. While the Delaware Division is regulated by the PSC, ESNG is regulated by FERC. Moreover, ESNG must obtain approval from the FERC before expanding its pipeline into eastern Sussex County and FERC is unlikely to approve such an expansion without a showing that sufficient customer demand is present in the area. Moreover, it is difficult to demonstrate that

customer demand exists unless a natural gas distribution system is available. So, to some extent, ESNG must rely upon the Delaware Division in order to have its expansion approved while the Delaware Division must rely upon ESNG's pipeline expansion in order to justify its expansion into new areas of Sussex County. This situation is hardly ideal when the two entities involved have common ownership, as is the case here." (Ex. 22, p. 18, LL 4-16)

43. Moreover, Ms. Crane testified that:

> "[t]he PSC should recognize that there is an inherent incentive for [Chesapeake] to subscribe to as much ESNG capacity as possible. Therefore, the fact that [Chesapeake] had excess capacity to sell, and sold it to PESCO for $0.17 per Dth, does not necessary mean ratepayers received a net benefit. If the Company decides to discontinue capacity release sales to PESCO, ratepayers will lose a credit of approximately $160,000 per year. However, the Company may then decide to procure less capacity for [Chesapeake] than it might otherwise, an action that could save ratepayers significantly more than the $160,000 credit that would be lost." (Ex. 22, p.18, LL 18-24)

44. Finally, Ms. Crane, testified that:

> "[p]erhaps more importantly, even if ratepayers did receive a net benefit from the capacity release revenues, that is no reason to abandon the asymmetric pricing principles agreed to by the parties and memorialized in the Settlement Agreement in PSC Docket No. 00-523. There may be isolated circumstances where a party decides to forego a transaction that could have had a benefit to ratepayers, due to a requirement for asymmetric pricing. However, asymmetric pricing principles are adopted because overall they provide the best protection to ratepayers against cross-subsidization. My point is that sometimes there is a principle that is bigger and more important to ratepayers than any one particular transaction. Asymmetric pricing is one of those principles." (Ex. 22, p.18, LL 25-28, p.19, LL 1-5-emphasis supplied)

45. Ms. Crane recommended as follows:

> 1) "The Company should be required to credit to ratepayers the difference between the cost of the ESNG capacity sold to PESCO and the revenues received from PESCO since November 1, 2007 through the latest month available. This is the incremental amount that ratepayers would have received during the current determination period, including the prior year true-up period, if [Chesapeake] had applied asymmetric pricing principles. Second, the Company should be required to adhere to its Settlement Agreement, including the asymmetric pricing principles contained therein, for all future capacity releases to PESCO, or to any other affiliate," and
>
> 2) "The Commission may want to review the circumstances in this case in light of its authority to impose penalties to determine if such a penalty is appropriate in this case for the failure of [Chesapeake] to comply with the terms of the Settlement Agreement in PSC Docket No. 00-523."[9] (Ex. 22, p.19, LL 19-21, p.20, LL 1-14)

D. CHESAPEAKE UTILITIES CORPORATION'S REBUTTAL TESTIMONY

46. On August 18, 2009, Chesapeake filed the Rebuttal Testimony of Jennifer Clausius, its Management of Pricing and Regulation. In her Rebuttal Testimony, Ms. Clausius testified first that the asymmetric pricing requirements set forth in the Settlement Agreement do not apply in this situation. According to Ms. Clausius, the temporary release of recallable interstate pipeline capacity is neither a transfer of an "asset" ownership, nor is it the provision of a "service" by the Company. This capacity is an asset of Chesapeake's Delaware Division for which ownership does not change hands. The Company's release of this capacity to PESCO, or any third party, allows only the temporary use of the Company's capacity.

47. According to Ms. Clausius, Chesapeake's Delaware

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[9] In light of the undeveloped terms of the Settlement Agreement in PSC Docket 07-246F, the Hearing Examiner recommends against holding the Company liable for any penalty. *See* 26 *Del. C.* 217, 218 and 308 addressing the assessment of a penalty by the PSC.

Division is also not providing a service to PESCO. (Ex. 24, p. 5, LL 14-23) Ms. Clausius argues that the Company does not provide transportation of the commodity and PESCO does not pay the Delaware Division anything. Once the Delaware Division releases the capacity, the service is being provided by ESNG. ESNG is the party which has dealings with PESCO in regards to the scheduling of the transportation of gas and use the capacity (dealings which the Delaware Division is not privy). ESNG is the party that bills PESCO for the capacity, and ESNG is the party that provides a credit to the Delaware Division for the release of the capacity. (Clausius, Ex. 22, pp. 5-6)

48. Ms. Clausius next argues in her Rebuttal Testimony that the intent of the Code of Conduct from PSC Docket 00-523 was to govern relations between Chesapeake's Delaware Division and completely unregulated affiliates, as opposed to affiliates which are regulated by FERC. (Clausius Ex. 24, p.6, LL 9-16) According to Ms. Clausius, FERC's regulation of capacity releases on interstate pipelines pre-empts any attempt by the Commission to impose asymmetrical pricing on the Company's capacity releases to PESCO. "FERC's regulations are designed to promote a competitive environment for all capacity releases. The competitive environment created by FERC eliminates the potential for behind the scenes subsidies between regulated utilities and their respective affiliates. More importantly, setting artificial price caps and floors runs totally counter to the goal of [the federal policy of] promoting a competitive environment for the release of capacity." (Clausius Ex. 24, p.6, LL 9-16)

49. Ms. Clausius disagrees with Mr. LeLash's and Ms. Crane's testimony that by releasing capacity at less than the maximum rate, the ratepayers are "subsidizing" the Company's unregulated activities. (Ex. 24, p.10) According to Ms. Clausius, Chesapeake's ratepayers are not subsidizing PESCO. The Company's ratepayers are receiving the same, or actually greater, credit to the GSR through the release of capacity than they were receiving when the Delaware Division was engaging in off-system sales. (Ex.

24, p.10 LL 14-16) Ms. Clausius argues that the amount of capacity obtained to serve the Company's firm customers is based on a calculation of the Company's design day to serve only those firm customers. At times during the year when this capacity is not being utilized by the firm customers, the Company releases this capacity to other parties in order to provide a benefit to the firm customers by way of a capacity release credit. "Eliminating the capacity release to PESCO would not eliminate the cost associated with this capacity. It would only serve to eliminate any added benefit the firm customers are receiving by way of the credit now being recognized." (Ex. 24, pp. 10-11) Ms. Clausius states that "Ms. Crane failed to state that the Maryland Division releases were significantly above $0.17 per Dth, and in fact, were at cost." (Ex. 24, pp. 13-14)

50. According to Ms. Clausius, the primary difference between capacity releases at the maximum rate and at less than the maximum rate are the rights associated with each. (Ex. 24, p. 14, LL 15-16) Chesapeake's Delaware and Maryland Divisions are both firm transportation customers of ESNG and, as such, have long-term agreements in place for firm capacity. The capacity which Chesapeake's Delaware and Maryland divisions release at the maximum tariff rate to the Company's firm transportation customers are physically connected to Chesapeake's distribution systems in Delaware and Maryland. As such, the company procures capacity to serve these customers on a design day. (Ex. 24, p.14, LL 15-23)

51. Ms. Clausius argues that the capacity released to PESCO is not procured by the Delaware Division to serve PESCO. (Ex. 24, p.14 LL 21-23, p. 15, LL 1) Rather, since the capacity is procured to serve firm customers and is anticipated to be recalled in the event of a design day, the Company is able to attach the fully recallable condition to its release. This condition makes the associated capacity "more reflective" of interruptible transportation capacity. This condition makes the capacity more risky for PESCO since the capacity may be recalled

by the Company for any reason before 6 p.m. on the day of release. "The Company would only recall the capacity issued to transportation customers if the customers switched back to sales customers.

52. According to Ms. Clausius, the capacity released to PESCO for the former off-system sales customers is released on a short-term basis of 31 days or less, while the capacity releases for transportation customers are typically for 1 year." (Ex. 24, p.15 LL 10-19) Ms. Clausius argues that, since the transportation customers are located on the Company's distribution system, they are required to obtain their ESNG capacity from Chesapeake. PESCO customers are not on the Company's distribution system and thus are not required to obtain their ESNG capacity from Chesapeake. (Ex. 24, p.15 LL 13-19)

53. Ms. Clausius testified that, "[a]t the [cost]rate, PESCO would be unable to serve these former off-system sales customers. As a result, PESCO would not need the capacity." (Ex. 24, p.17 LL 9-10) "First, PESCO is not the only marketer doing business in Delaware that would be interested in serving these customers. It is possible, and highly likely, that another marketer could get capacity from a source at a rate lower than the maximum rate and serve the customers themselves." Also, Ms. Clausius argued that PESCO's off-system sales customers have alternative fuel sources available to them if natural gas becomes too expensive if asymmetrical pricing principles are utilized. (Ex. 24, p.17 LL 13-23)

IV. DISCUSSION

A. LEGAL ISSUES IN PHASE II

1. Is Chesapeake required to apply asymmetric pricing principles according to the Settlement Agreement in PSC Docket 00-523 (PSC Order No. 5828, November 6, 2001) and/or the Settlement Agreement in PSC Docket 07-246F (PSC Order No. 7450, October 7, 2008)?

2. Does Chesapeake's practice comply with 26 *Del. C* § 303 entitled "Unjust and unreasonable rates and preferences…"?

3. Does the Delaware Public Service Commission (PSC) or the Federal Energy Regulatory Commission (FERC) have jurisdiction as to the price to be charged to Delaware ratepayers for capacity releases from Chesapeake's affiliate Eastern Shore Natural Gas to Chesapeake's affiliate PESCO?

B. FACTUAL BACKGROUND IN PHASE II

54. In Phase I, the Commission issued PSC Order No. 7607 (July 7, 2009) approving Chesapeake's application for modifications to its Gas Sales Service rates ("GSR"); and 2) authorizing Phase II of this Docket. Phase II addresses how Chesapeake must account to its Delaware ratepayers for certain transactions Chesapeake makes with its sales subsidiary PESCO and Eastern Shore Natural Gas ("Eastern Shore"), its natural gas transmission subsidiary.

56. Chesapeake contracts with Eastern Shore for capacity[10] i.e. the right to have Eastern Shore transport natural gas to meet Chesapeake's anticipated needs to service its ratepayers. Typically, these contracts extend up to three (3) or four (4) years in the future, at rates specified in tariffs filed with FERC. (Ex. 24, Clausius, p.9, LL 21-22, p.10, LL 1-2) Until Docket No. 07-246F was completed in 2008, Chesapeake, in addition to its regulated sales, also made shorter term, off-system sales ("OSS sales") and it purchased sufficient capacity to service its OSS customers. In Docket No. 07-246F, Chesapeake agreed to cease

[10] "Capacity" means the contractual right of Chesapeake to have Eastern Shore transport natural gas to Chesapeake's terminals at certain times, in certain quantities expressed in dekatherms or "DTH." (DPA's Answering Brief, p. 3)

directly making OSS sales and Chesapeake transferred those OSS customers to its marketing subsidiary or "affiliate," PESCO. Currently, Chesapeake releases some of its capacity to PESCO, with which PESCO services Chesapeake's former OSS customers. Beginning in January, 2008, PESCO purchased Eastern Shore capacity released by Chesapeake to sell to Chesapeake's former OSS customers. (Chesapeake's Opening Brief, p. 1; Clausius, Ex. 24, p.16, LL 4-7) In the "design" of its capacity release rate,[11] Chesapeake's capacity forecasts and purchases include capacity which Chesapeake anticipates releasing to PESCO. (Chesapeake's Opening Brief, p.2)

57. The capacity rate[12] which Chesapeake pays Eastern Shore is approximately $.5915/DTH.[13] This $.5915/DTH cost has been passed through to Chesapeake's Delaware ratepayers in their monthly gas bills. (DPA's Opening Brief, p.3) The compensation Chesapeake receives from PESCO for the capacity Eastern Shore releases to Chesapeake's subsidiary PESCO is only $.17/DTH. (DPA's Opening Brief, p.3) Thus, Chesapeake's Delaware ratepayers are paying $.4215/DTH more or over 3 times as much than PESCO is being charged. As a result, during the period of January 2008 through May 2009, the Company received $388,223 from PESCO for the releases while paying Eastern Shore Natural Gas ("ESNG") charges for the capacity totaling $1,305,788." (Lelash, Ex. 23A, p.2, LL 20-21, p.3, LL 1-5)

C. 2001 SETTLEMENT AGREEMENT IN PSC DOCKET 00-523

58. The legal issues in this Docket were previously addressed for the most part by the PSC in Docket Nos. 00-523 and 07-246F. I will first discuss PSC Docket 00-523. PSC Docket 07-

[11] "Capacity release rate" means the credit per DTH Chesapeake receives for the capacity it releases to PESCO. (DPA's Answering Brief, p. 3)
[12] "Capacity rate" means the cost to Chesapeake per dekatherm ("DTH") for long term capacity (DPA's Answering Brief, p. 3)
[13] "DTH" or dekatherm is a unit of energy equal to 10 therms or one million British thermal units (MMBtu). (DPA's Answering Brief, p. 3)

246F will be discussed later. By way of background, 26 *Del. C.* § 201 provides that "the Commission shall have exclusive supervision and regulation of all public utilities and also over their rates ...." Moreover, 26 *Del. C.* §209(a)(1) permits the Commission to "fix just and reasonable standards, classifications, regulations, practices ... or services to be furnished, imposed, observed and followed thereafter by any public utility."

1. The 2001 Settlement Agreement

In PSC Docket 00-523, by PSC Order No. 5828 dated November 6, 2001 (2001 Del. PSC LEXIS 195), the Commission approved a Settlement Agreement regarding Chesapeake which required as follows in Paragraph II(13):

> Marketing Affiliate. .... The Company agrees that if the Company decides to own and/or operate a Marketing Affiliate, or if its Non-Utility operations are selling natural gas in Delaware, the additional code provisions set forth in Appendix I of Exhibit A attached hereto will automatically apply. (emphasis supplied)

Exhibit "A", Paragraph B of the "Codes of Conduct" in the 2001 Settlement Agreement require as follows:

B. General Standards or Codes of Conduct

The following Standards of Conduct shall apply to transactions between Chesapeake Utilities Corporation-Delaware Division,[14] Non-Regulated Activities,[15] and Third

[14] Paragraph (A)(2)-entitled "Definitions for Code of Conduct" provides as follows:
2. **"Chesapeake Utilities Corporation - Delaware Division"** shall mean the regulated operations of the natural gas distribution utility providing natural gas service to customers in New Castle County, Kent County and Sussex County, Delaware under a natural gas tariff approved by the Delaware Public Service Commission.

[15] Paragraphs (A)(1) and (A)(4) provides as follows:
1. **"Non-Regulated Activities"** shall mean any business activities, services or products of Chesapeake Utilities Corporation or its non-regulated business affiliates and/or subsidiaries whose revenues and costs are not included in the determination of utility rates and are not subject to the regulatory authority of the Delaware Public Service Commission.

Parties.[16]

3. Chesapeake Utilities Corporation-Delaware Division or any Non-Regulated Activities may not represent that the utility will give any preference to a customer or others in the use of Natural Gas Distribution Utility Services as a result of that customer or others dealing with the Non-Regulated Activities.

4. Chesapeake Utilities Corporation-Delaware Division may not give any preference to its Non-Regulated Activities or customers of its Non-Regulated Activities in the provision of Natural Gas Distribution Utility Services.

Paragraph II(10) of the 2001 Settlement Agreement entitled "Pricing Principles" requires as follows:

> "…[F]or transfer of assets between Regulated Activities ("Chesapeake") and Non-Regulated Activities,("Affiliate") asymmetrical pricing principles (i.e. for transfers from Chesapeake to the Affiliate, the higher of fully allocated cost or market price) … shall apply.
>
> Asymmetrical pricing principles shall also apply to the provision of services, exclusive of shared services or common support services…."
>
> (emphasis supplied)

D.COMPANY'S PRACTICE VIOLATES PSC DOCKET 00-523

59. Chesapeake's practice of charging more than three (3) times the cost of the gas to Delaware ratepayers than that charged to its affiliate PESCO for sale to PESCO's off-system customers, has violated Paragraph II(10) of the 2001 Settlement

4. **"Regulated Utility Activities"** shall mean, at any given time, any of Chesapeake Utilities Corporation - Delaware Division natural gas distribution operations or practices subject by law to regulation by, and the ratemaking authority of, the Delaware Public Service Commission.

[16] Paragraph (A)(10) provides as follows:
10. **"Third Party,"** individually, and "Third Parties," collectively, shall mean any business enterprise or entity that does not include Chesapeake Utilities Corporation - Delaware Division or Non-Regulated Activities set forth above.

Agreement above. I find that Paragraph II(10) has been violated because a "transfer of assets between regulated activities" has occurred, and alternatively, because a "service" is involved. I find that Paragraph II(10) required Chesapeake to use asymmetrical pricing even if, as Chesapeake argues, the gas released to PESCO was recallable by Chesapeake for use by Delaware ratepayers for use on a "design day" or otherwise.

60. I concur with Andrea Crane, DPA's expert, who persuasively testified as follows as to: 1) why Chesapeake's practice violates PSC Order No. 5828 in Docket 00-523 and the parties' Settlement Agreement; and 2) that an "asset" and/or "service" triggering Paragraph II(10)'s asymmetrical pricing requirement:

> "The asymmetric pricing principles in the Settlement Agreement were designed to cover both transfers of balance sheet items, i.e., assets, as well as transfers impacting the income statement, i.e., services. If [Chesapeake] is not selling either an asset or a service, then what are they being paid for by PESCO? There is obviously some item of value being transferred. [Black's Law Dictionary 8th ed. 2004 defines an asset as "an item which is owned and has value."] Since capacity costs are generally expensed by a utility, I would consider the provision of capacity to [also] be a service in this case." (Crane, Ex. 22, p. 12, LL 7-18)

61. Additional compelling testimony from Ms. Crane is to why a "service" triggering Paragraph II(10)'s asymmetrical pricing requirement was as follows:

> "While [Chesapeake] is not directly providing transportation service to PESCO, it is providing the right to receive that transportation service, which is purchased from ESNG. PESCO is receiving a service from [Chesapeake]. Whether one characterizes that service as transportation service or as the right to receive transportation service from ESNG, a service is being provided by [Chesapeake] to

PESCO as a result of the capacity release transaction." (Crane, Ex. 22, p. 13, LL 2-6)

"Moreover, the fact that the provision of capacity is provided pursuant to ESNG's tariff is immaterial in this case. That tariff does not address the pricing of affiliated transactions to Delaware retail customers. That ratemaking issue is the purview of the PSC. Moreover, that ratemaking treatment has already been determined by the parties in the Settlement Agreement in PSC Docket No. 00-523." (Crane, Ex. 22, p. 13, LL 7-11)

"The purpose of asymmetric pricing principles is to ensure that ratepayers do not subsidize unregulated activities." (Crane, Ex. 22, p. 14, LL 13-14)

62. The Company's practice also violates Paragraphs B(3) and B(4) of the "General Standards or Codes of Conduct" (hereinafter "Codes of Conduct") contained in the parties' 2001 Settlement Agreement. In the 2001 Settlement Agreement, Chesapeake agreed that "if the Company decides to own and/or operate a Marketing Affiliate or its non-utility operations are selling gas in Delaware," Chesapeake was required to comply with the following Codes of Conduct:

<u>B. General Standards or Codes of Conduct</u>

The following standards of conduct shall apply to transactions between Chesapeake Utilities Corporation - Delaware Division, Non-Regulated Activities and Third Parties:

3. <u>Chesapeake Utilities Corporation-Delaware Division or any Non-Regulated Activities may not represent that the utility will give any preference to a customer or others in the use of Natural Gas Distribution Utility Services as a result of that customer or others dealing with the Non-Regulated Activities.</u>

4. <u>Chesapeake Utilities Corporation - Delaware Division may not give any preference to its Non-Regulated Activities or customers of its Non-Regulated Activities in the provision of Natural Gas Distribution Utility Services.</u> (Exhibit "A" of 2001 Settlement Agreement, p.2)

63. Due to Chesapeake's practice of charging its Delaware ratepayers more than three (3) times the cost of gas than that paid by its affiliate PESCO for sale to PESCO's off-line customers, Chesapeake has also violated Codes of Conduct (B)(3) and B(4) above. These Codes each require that, in applying Chesapeake's Natural Gas Tariff,[17] Chesapeake or PESCO may not give a price "preference" to PESCO's non-regulated customers over Chesapeake's Delaware's regulated ratepayers. A "preference" is defined as "[t]he act of favoring one person or thing over another." (*See* Black's Law Dictionary 8th Ed.) In its post-hearing Brief, the DPA states that Chesapeake is engaging in "self-dealing." (*See* DPA's Answering Brief, p.5.)

64. Since asymmetrical pricing is required by Paragraph II(10) of the parties' Settlement Agreement and price preferences are not permitted by Codes of Conduct B(3) and B(4), I am persuaded that the PSC Staff and the DPA are correct in recommending that the Commission order that Chesapeake credit the GSR (i.e. Delaware ratepayers) the difference between the amount Chesapeake paid its affiliate Eastern Shore Natural Gas and the amount paid by the Company's affiliate PESCO, beginning in January 2008 through the present, as detailed by Staff's expert LeLash. (LeLash, Ex. 23A, p.3, LL 1-5)

[17] Chesapeake filed its revised Natural Gas Tariff on September 17, 2008 pursuant to PSC Order No. 7434 (September 2, 2008) for bills to its Delaware ratepayers rendered on or after September 3, 2008. Section XVI of that Tariff addresses the "Application of Rates." In the instant case, however, capacity is provided pursuant to the Chesapeake's contract for capacity with Eastern Shore, which does not address the release rate. (Ex. 24, p.12, LL 3-8) However, the price charged to Delaware ratepayers triggers Chesapeake's Natural Gas Tariff, and the parties' Settlement Agreement in PSC Docket 00-523, including but not limited to the asymmetrical pricing requirement and the Codes of Conduct. *See also* <u>Georgia Pacific Corporation v. Delmarva Power & Light Company</u>, 1992 Del. Ch. LEXIS 270 (Del. Chan. 1992)(PSC had "exclusive jurisdiction" over claims which involved an interpretation of a regulated electric company's Tariff)

E. Company's Practice Violates 26 Del. C § 303(a)

65. I find that Chesapeake's practice also violates 26 *Del. C* § 303(a). That statute and §307(a) addressing Chesapeake's Burden of Proof in this rate proceeding require as follows:

> **§ 303. Unjust or reasonable rates and preferences; change in fuel adjustment rate; economic development credit for qualifying corporations.**
>
> a) <u>No public utility shall make, impose or exact any unjust or unreasonable or unduly preferential or unjustly discriminatory individual or joint rate for any product or service supplied or rendered by it within the State, or adopt, maintain or enforce any regulation, practice or measurement which is unjust, unreasonable, unduly preferential or unjustly discriminatory or otherwise in violation of law,</u> or make, or give, directly or indirectly, any undue or unreasonable preference or advantage to any person or corporation or to any particular description of traffic, in any respect whatsoever.
>
> **§ 307. Burden of proof; speedy determination**
>
> a) In any proceeding upon the motion of the Commission, or upon complaint, or <u>upon application of a public utility, involving any proposed or existing rate of any public utility, or any proposed change in rates, the burden of proof to show that the rate involved is just and reasonable is based upon the public utility.</u>
>
> (Emphasis Supplied.)

66. Regarding 26 *Del. C.* §303(a), it is the Hearing Examiner's recommendations that: 1) the asymmetrical pricing requirements of PSC Docket 00-523's Settlement Agreement are consistent with, and based upon 26 *Del. C* § 303(a); 2) for the reasons described previously, Chesapeake's practice violates 26 *Del. C* § 303(a) because charging Delaware's regulated ratepayers three (3) times the amount paid by PESCO is an "unjust, unreasonable… [and] unduly preferential" rate and gives an "undue

and unreasonable preference" to PESCO's customers over Delaware ratepayers; and 3) I find that Chesapeake has not satisfied its burden of proof that the proposed rate is "just and reasonable" as required by §307(a) above.

F. 2008 Settlement Agreement in PSC Docket 07-246F

67. Chesapeake relies upon the Settlement Agreement in the prior GSR case, PSC Docket 07-246F and Order 7450 (October 7, 2008), which provided in Paragraphs 11, 12 and 15 as follows:

> 11. <u>The Company agrees that it will credit the GSR, on an on-going basis, for 100% of the revenues received by the Company for any capacity released to serve former off-system sales customers. The credit will be designed to equate to what would have been credited through the margin sharing mechanism had these off-system sales customers remained off-system sales customers of the Company.</u> The parties acknowledge that the amount of the credit may fluctuate in the event of a change in load of a particular customer or if a particular customer no longer needs capacity.
>
> 12. The Settling Parties agree that the Company's proposed rates as set forth in the Company's Application and Supplemental Application are just and reasonable rates. <u>The Company acknowledges that the Company's Supplemental Application only reflected updates to the Company's gas costs. The parties agree that all matters related to such updates are subject to review and modification, if required, in the Company's next GSR proceeding for the determination period November 1, 2008 through October 31, 2009.</u>
>
> 15. ...<u>[N]one of the Settling Parties waives any rights it may have to take any position in future proceedings regarding the issues in this proceeding, including positions contrary to positions taken herein or previously taken.</u> (emphasis supplied)

68. After reviewing the Settlement Agreements in PSC Docket 00-523 and 07-246F and the arguments of the parties, the Hearing Examiner agrees with Staff's and the DPA's position that the Settlement Agreement in Docket 00-523 supersedes the Settlement Agreement in Docket 07-246F. I also find that Paragraphs 12 and

15 above specifically permits Staff and the DPA to now request that the Commission disallow Chesapeake's practice now that Staff and the DPA have, through extensive discovery in this Docket, become aware of Chesapeake's practices involving PESCO. In its Brief, Staff argued as follows:

> "Finally, the Company contends that the settlement in Docket No. 07-246F supersedes the settlement in Docket No. 00-523 with respect to the specific matters addressed in the Docket No. 07-246F settlement. (Company's Initial Brief at p.7). Not so. When the parties entered into the settlement in Docket No. 07-246F, there was little information available about the Company's capacity releases to PESCO, and no information about the level of sales to PESCO. Thus, the matter cannot be considered to have been "specifically addressed." In Phase II of this docket, however, Staff and the Public Advocate obtained more information through discovery, and that information caused Staff and the Public Advocate to become concerned that Delaware retail ratepayers were subsidizing Chesapeake's non-Delaware regulated affiliate PESCO. Simply because Staff and the Public Advocate agreed to this sharing mechanism in Docket No. 07-246F does not mean they are forever wedded to it. Indeed, the Docket No. 07-246F settlement agreement specifically states: "Except as expressly set forth below, none of the Settling Parties waives any rights it may have to take any position in future proceedings regarding the issues in this proceeding, including positions taken contrary to positions taken herein or previously taken." (Docket No. 07-246F Settlement Agreement, ¶ 15, page 6)." (Staff's Opening Brief, p. 12)

69. Although Chesapeake does not cite any record evidence from PSC Docket 07-246F, Chesapeake's Opening Brief in this Docket argues as follows:

> "In PSC Docket No. 07-246F, the Company informed the parties that the historical five-year average of OSS margins credited to the firm

> customers totaled approximately $160,000 per year. Consistent with the proposed settlement in that docket, the Company informed the parties that the Company would release capacity to PESCO at a rate that would equate to a credit for capacity release revenue approximating the 5-year average annual margin share under the discontinued OSS program. (Ex. 21 at 8) At no time did the Company state that the capacity release rate would be equal to the higher of "cost" or "market". The settlement in PSC Docket 07-246F did not require that the release rate be equal to the higher of "cost" or "market".
>
> Consistent with the settlement, the Company designed a proposed capacity release rate of $0.17 per dekatherm ("DT") for recallable capacity released to PESCO for use by PESCO to serve OSS customers. This capacity release rate was intended to approximate the GSR credit for the Delaware firm ratepayers under the discontinued OSS program. In designing the rate, the Company divided $160,000 by the number of DT's that the Company estimated PESCO would need to serve the OSS customers, and arrived at a rate of $0.17 per DT. (Ex. 21 at p.9)." (*See* Chesapeake's Opening Brief, p. 2)

70. The Company does not give any explanation from the record evidence in PSC Docket No. 07-246F regarding the intent of the Docket 07-246F Settlement Agreement. In this Docket, there is no record evidence that the Company informed Staff in Docket 07-246F that the Company intended to release capacity to its subsidiary at less than one-third of the cost credited to Delaware ratepayers thereby violating the Commission's Order in PSC Docket No. 00-523 and 26 *Del. C.* § 303(a). I find that, regardless of the language of the Settlement Agreement in Docket 07-246F above, however, the Company's current practice does not comply with the requirements of 26 *Del. C.* § 303(a) and the Commission's Order in PSC Docket No. 00-523. Since the Company's practice does not comply with 26 *Del. C.* § 303(a) and the Commission's Order in PSC Docket 00-523, I recommend that the Commission disallow the Company's practice.

G. **<u>The PSC Has Jurisdiction.</u>**

71. The Commission has jurisdiction in this matter pursuant to 26 *Del. C.* § 201 and 26 *Del. C.* § 303(b). 26 *Del. C.* § 201 provides that "the Commission shall have exclusive supervision and regulation of all public utilities and also over their rates …." 26 *Del. C.* §209(a)(1) permits the Commission to "fix just and reasonable standards, classifications, regulations, practices … or services to be furnished, imposed, observed and followed thereafter by any public utility." Additionally, as described previously, 26 *Del. C* § 303(a) provides as follows:

> **§ 303. Unjust or reasonable rates and preferences; change in fuel adjustment rate; economic development credit for qualifying corporations.**
>
> (a)No public utility shall make, impose or exact any unjust or unreasonable or unduly preferential or unjustly discriminatory individual or joint rate for any product or service supplied or rendered by it within the State, or adopt, maintain or enforce any regulation, practice or measurement which is unjust, unreasonable, unduly preferential or unjustly discriminatory or otherwise in violation of law, or make, or give, directly or indirectly, any undue or unreasonable preference or advantage to any person or corporation or to any particular description of traffic, in any respect whatsoever.

72. The parties agree that FERC has asserted jurisdiction over capacity releases. (*See* Chesapeake's Opening Brief, p.8; Staff's Answering Brief, p.13, DPA's Answering Brief, p.2.) However, FERC's jurisdiction is not without limits. The Natural Gas Act, 15 U.S.C. §717, the same statute from which FERC derives its regulatory authority, provides that states have the sole authority to regulate the rates which a local distribution

company with intrastate business such as Chesapeake charges its retail customers or ratepayers. *See* 15 U.S.C. §717(b) retail gas sales are specifically excluded from federal regulation by FERC). In Kentucky West Virginia Gas Company v. Pennsylvania Public Utility Commission (PUC), 837 F.2d 600, 608 (3d Cir. 1988), the Third Circuit Court of Appeals construed a Pennsylvania state statute and held as follows:

> "If a distributor buys gas at wholesale and then sells it at retail, the state, not FERC, sets the rate for that second sale. In evaluating that retail rate under §1318 [the Pennsylvania state statute], the state should not be forestalled from considering the prudence of the distributor's purchased gas costs in establishing the cost of retail service. Since the question here of whether the retailer acted with economic prudence in purchasing from one wholesaler rather than another is never before FERC, the PUC is not regulating the same activity."

73. Construing the Pennsylvania statute, the court held that, if a utility purchases all or part of its natural gas from an affiliated interest, the PUC was permitted to determine the justness and reasonableness of gas purchases from the affiliate. (*Id.* at 602.) The utility argued that the State was preempted from determining the prudence of the utility's decision to purchase gas from one source as opposed to another, before permitting the utility to pass the cost through to ratepayers at wholesale rates approved by FERC. (*Id.*) Since the subsidiary Kentucky West was selling 70% of the gas it produced to its parent company, the PUC wanted to determine that the parent company utility was pursuing the "least cost fuel procurement

policy consistent with its obligation to provide safe, adequate, and reliable service to its customers." (*Id.*) The Third Circuit Court of Appeals held for the PUC stating that retail gas sales are specifically excluded from federal regulation by FERC by 15 U.S.C. §717(b).(*Id.*) The court held that "a long-standing maxim of utility regulation jurisprudence [is] that states may legitimately exercise authority over intrastate utility rates." (*Id.* at 607.)

74. "In a standard retail sale, the end-user purchases gas from an LDC at the local delivery point without regarding to the upstream transaction." (*See* United Distribution Companies, *infra*, at 1157.) Although "a standard retail sale" is not involved here, since the rate which Delaware ratepayers alone pay for their natural gas is involved, and such rate is affected by Chesapeake's subsidiary PESCO's sales to its own customers, the Commission has jurisdiction because: 1) 15 U.S.C. §717(b) excludes retail sales from FERC's jurisdiction; and 2) the Kentucky West Virginia Gas Company decision discussed above held that the Pennsylvania Commission was permitted to determine the justness and reasonableness of gas purchases from the subsidiary in exercising authority over intrastate utility rates. (*See also* In The Matter of the Application of Delmarva Power & Light Company For Approval Of An Increase In Its Gas Cost Adjustment (Filed 9/9/88); 1990 Del. PSC Lexis 22 (April 9, 1990) (holding that PSC may "redesign [gas] top cost rates and reclassify them

to fairly allocate the burden, in accordance with its local regulatory law practice, among the retailer's ratepayers")

75. In the instant case, Staff and the DPA argue, and the Hearing Examiner agrees, that the Commission would not be interfering with nor affecting the rate which FERC has set or will set for capacity releases, nor the access to or the manner in which the capacity is acquired. Rather, the Commission is permitted to require that the rate charged to Chesapeake's Delaware retail customers include a credit in the full amount of the FERC-approved maximum rate for pipeline capacity releases when Chesapeake releases pipeline capacity to its non-regulated subsidiary PESCO. Staff's and the DPA's position, in which the Hearing Examiner concurs, is that Chesapeake may continue to sell its excess pipeline capacity to its affiliate PESCO at 17 cents per Dth just as it does now or any other rate which Chesapeake wants. (Staff's Answering Brief, p.14; DPA's Answering Brief, p.6.) Staff and the DPA are obviously concerned with what the Company's Delaware ratepayers are charged.

76. Moreover, even in precedent relied upon by Chesapeake, FERC acknowledged that states may also assert their own jurisdictional authority regarding how much interstate pipeline capacity a utility should hold capacity, including whether the utility would be required to obtain or relinquish capacity. In <u>Georgia Public Service Commission</u>, 107 F.E.R.C. ¶61,024, 2004 FERC WESTLAW 821537, 2004 FERC LEXIS 727 (FERC Apr. 15, 2004), FERC stated:

> The GPSC [Georgia Public Service Commission] has authority to mandate how much interstate pipeline capacity Atlanta [the LDC] or a Georgia marketer should hold. Thus, for example, it can order Atlanta to obtain more capacity if needed, or to relinquish unneeded capacity so that Georgia consumers do not have to pay for such unneeded capacity. The same holds true for the GPSC's regulation of Georgia marketers. However, the GPSC's regulation of *access to, use of and recall or reversion of such interstate pipeline capacity* appears to intrude on the Commission's exclusive jurisdiction over such matters. The GPSC, through its regulation of Atlanta and Georgia marketers, appears to be essentially regulating who interstate pipelines may serve, where such service may be provided, and for what levels of service. (*See* Georgia Public Service Commission, *Id.* at 49 (emphasis supplied)).

77. In Georgia Public Service Commission (GPSC), a Georgia unbundling statute required local distribution companies ("LDCs") and marketers subject to the GPSC's jurisdiction to propose plans for the assignment of interstate capacity held by the Atlanta Gas Light Company. (*Id.* at 37.) The GPSC was required to hold a hearing on the proposed plan before the GPSC could adopt the plan. The statute specifically stated that:

> If adopted, the plan *shall* provide for interstate capacity to be assigned to certificated marketers who desire assignment and who are qualified technically and financially to manage interstate capacity assets. Marketers who accept assignment of interstate capacity assets *shall be required* by the [GPSC] *to use such assets primarily to serve retail customers in Georgia* and shall be permitted to use such assets outside Georgia so long as the reliability of the system is not compromised. (*Id.* at 41.) (emphasis supplied)

78. Pursuant to the Georgia statute, the GPSC was presented with proposed plans from a LDC and a marketer. (*Id.*) The GPSC filed a Petition for Declaratory Order with FERC to determine whether FERC would preempt the adoption of the GPSC's plans. (*Id.*) These proposed plans provided for the permanent assignment of interstate assets held by the LDC to certificated natural gas marketers and placed conditions upon the assignment of the LDC's interstate capacity assets. (*Id.*) FERC concluded that federal law would preempt the GPSC if it were to adopt the proposed plans because the plans would allow the GPSC to regulate access to capacity on interstate pipelines which is within FERC's exclusive jurisdiction. (*Id.* at 46-47). FERC stated that:

> We find that the restriction on the use of interstate capacity under Scana's [the marketer's] plan is at odds with the Commission's pro-competition, open-access regulatory policies by allowing Atlanta [the LDC], or whomever the GPSC designates, to control disposition of interstate capacity solely to benefit Georgia customers. As Scana [the marketer] states that, under its plan, following an assignment by Atlanta [the LDC] to a Georgia marketer, if the marketer did not want to renew the contract, or if a specified event required the marketer to assign back its capacity (e.g., a market share drop), the marketer would be required to assign the capacity back to a party designated by the GPSC, i.e., another Georgia marketer servicing only Georgia customers. Because under Scana's [the marketer's] plan the interstate capacity generally in such situations would be used to benefit Georgia consumers, Scana's [the marketer's] plan removes that capacity from the interstate market ....Scana's plan, which assigns [the LDC's] capacity to Scana and/or other Georgia certified marketers, would restrict access to that interstate

> capacity only to other Georgia marketers or [the LDC]. (*Id.* at 46.)

79. In this Docket, the Delaware Public Service Commission is not being asked to regulate Chesapeake's access to capacity which the court prohibited in the Georgia Public Service Commission case discussed above. Moreover, the Commission is not being asked to 1) restrict Chesapeake's ability to release capacity to PESCO on the interstate market; 2) restrict PESCO's ability to purchase Chesapeake's released capacity; and 3) the Commission would not be setting rates for Chesapeake's capacity releases to its subsidiary PESCO. Chesapeake can continue to charge PESCO 17 cents per Dth for released capacity or whatever price Chesapeake desires, and PESCO can then sell that capacity to PESCO's customers for whichever price it can obtain. However, because PESCO is Chesapeake's affiliate and the rate at which Chesapeake releases capacity to its affiliate affects the rate Delaware ratepayers pay for their natural gas, the Commission may require Chesapeake to apply asymmetrical pricing. Requiring Chesapeake to comply with asymmetric pricing for its subsidiary PESCO does not in any way restrict access to interstate capacity, and is therefore not preempted by FERC because it "is not applied in such a way as to interfere with [the] federal regulatory scheme." (*See* Kentucky West Virginia Gas Company, 837 F.2d at 608; see also Georgia Pacific, cited in footnote 17, *supra*.)

80. Chesapeake also argues that requiring PESCO to pay the maximum FERC-approved rates would be "unduly discriminatory" as

PESCO's competitors would be favored, allegedly in violation of FERC regulations. (*See* Company's Opening Brief at 14.) Chesapeake's argument ignores that Chesapeake can continue to charge PESCO 17 cents per Dth for the capacity (or whichever rate Chesapeake desires), and PESCO can then sell that capacity to PESCO's customers for whatever price it may obtain. (*See* Staff's Answering Brief at 17.) However, based upon the prior authorities referenced herein, the Commission should require Chesapeake credit to the GSR the difference between the price that Chesapeake paid and the price PESCO paid.

81. Again, from January, 2008 through May 2009, Chesapeake received only $388,223 from PESCO for pipeline capacity Chesapeake released to PESCO to serve PESCO's customers, while Chesapeake paid ESNG $1,305,788 for that same pipeline capacity - a difference of $917,565. (Exh. 23A, Lelash, p.3.) The purpose of the Natural Gas Act is "to protect consumers against exploitation at the hands of natural gas companies." FPC v. Louisiana Power & Light Co., 406 U.S. 621, 623 (1972).

H. Chesapeake's Argument That FERC Has Jurisdiction.

82. Chesapeake unpersuasively argues that FERC's regulatory authority over capacity releases preempts this Commission from exercising regulatory authority as to what Chesapeake can charge Delaware ratepayers for natural gas sold by Chesapeake's affiliate PESCO to third party customers. (*See* Company Opening Brief at 8-17, *citing* United Distribution Companies v. Federal Energy Regulatory Commission, 88 F.3d 1105 (D.C. Cir. 1996),

cert. denied sub nom., Associated Gas Distributors v. Federal Energy Regulatory Commission, 520 U.S. 1224 (1997) (upholding FERC jurisdiction over capacity release issues, discussed *infra*) and *In re*: Georgia Public Service Commission, 107 F.E.R.C. ¶61,024, 2004 FERC WESTLAW 821537, 2004 FERC LEXIS 727 (FERC Apr. 15, 2004) (discussed *supra*). As demonstrated previously herein, FERC's authority in this area is not without limits.

83. Chesapeake accurately argues that FERC regulates the transportation and storage of natural gas in interstate commerce pursuant to authority granted to it in the Natural Gas Act. (*See* 15 U.S.C. §717.) FERC'S authority includes jurisdiction over interstate pipeline transportation service agreements involving shippers and the temporary or permanent assignment or release of the shippers' firm service capacity rights under such pipeline service agreements. (*Id.*) "Retail gas sales" are specifically excluded from FERC's jurisdiction by §717(b) of the Natural Gas Act. "In a standard retail sale, the end-user purchases gas from an LDC at the local delivery point without regarding to the upstream transaction." (*See* United Distribution Companies, 88 F.3d at 1157.)

84. Chesapeake also accurately argues that FERC Order No. 636 created a comprehensive capacity release program to increase the availability of unbundled firm transportation capacity by permitting firm shippers to release their capacity to others when they are not using it. (*Id.* at 1149.) FERC's capacity release

rules in Order No. 636 were further developed in Order No. 637[18] and were recently further amended in Order No. 712.[19] FERC's currently effective capacity release rules are set forth at 18 C.F.R. §284.8 (2009).

85. However, Chesapeake then unpersuasively argues that the Commission is pre-empted from determining the retail rate to be charged Delaware ratepayers because of one court's holding that the imposition of the "highest bidder" aspect of FERC's capacity release rules pre-empted a California "buy-sell" program that allowed end-users to contract with a local distribution company (LDC) without participating in the open bidding process. United Distribution Companies v. Federal Energy Regulatory Commission, 88 F.3d 1105, 1156 (D.C. Cir. 1996) ("United Distribution") The court in United Distribution held that FERC's statutory authority over the interstate transportation of natural gas would be compromised if it did not also have jurisdiction over the assignment of the contractual right to receive that interstate transportation by the end-user. (*Id.*) Since the "capacity release" program established competitive bidding for the right to receive that interstate transportation, the court concluded that

[18] Regulation of Short-Term Natural Gas Transportation Services and Regulation of Interstate Natural Gas Transportation Services, Order No. 637, FERC Stats. & Regs. ¶ 31,091 at 31,300, *clarified*, Order No. 637-A, FERC Stats. & Regs. ¶ 31,099, *reh'g denied*, Order No. 637-B, 92 FERC ¶ 61,062 (2000), *aff'd in part and remanded in part sub nom.*, Interstate Natural Gas Ass'n of America v. FERC, 285 F.3d 18 (D.C. Cir. 2002), *order on remand*, 101 FERC ¶ 61,127 (2002), *order on reh'g*, 106 FERC ¶ 61,088 (2004), aff'd sub nom. American Gas Ass'n v. FERC, 428 F.3d 255 (D.C. Cir. 2005).

[19] Promotion of a More Efficient Capacity Release Market, Order No. 712, 123 FERC ¶61,286 (2008); Order No. 712-A, 125 FERC ¶61,216 (2008); Order No. 712-B, 127 FERC ¶61,057 (2009).

the FERC had jurisdiction to enact the capacity release rules. (*See* United Distribution, 88 F.3d at 1152.)

86. Chesapeake unpersuasively argues that "FERC's interest in promoting a competitive capacity release market is reflected in its reaction in Order No. 636 to "buy-sell" programs." (*See* Company Opening Brief, p.11.) Under a buy-sell program, such as that approved in California, the natural gas consumer (the "end-user") and a local distribution company ("LDC") act in concert to move the natural gas from the wellhead to the "spigot" of the end-user. First, the end-user purchases natural gas at the point of production. Next, the LDC purchases the gas from the end-user and transports the purchased gas under the LDC's own transportation rights on an interstate pipeline and later across the LDC's local distribution facilities. Thus, the "routing" of the purchased natural gas spans both the FERC's jurisdiction (the interstate pipeline) and the state's jurisdiction (the local distribution facilities). (*See* United Distribution, 88 F.3d at 1154-1155.) FERC asserted its authority to ban "buy-sell" arrangements, because "they offer a ready means of circumventing the open, nondiscriminatory bidding process central to capacity release...(because) in a 'buy-sell' transaction ... the end-user can contract with an LDC without being forced to compete with other shippers that value the capacity...." (*See* United Distribution, 88 F.3d at 1156.)

87. Staff and the DPA argue, and the Hearing Examiner agrees that, unlike with buy-sell agreements, in the instant

case, the Commission would not be interfering with nor affecting the rate which FERC has set or will set for capacity releases, nor the access to or the manner in which the capacity is acquired by Chesapeake and then PESCO and then sold to PESCO's customers. Rather, the Commission is permitted to require that the retail rate to be charged to Chesapeake's Delaware retail customers includes a credit in the full amount of the FERC-approved maximum rate for pipeline capacity releases when Chesapeake releases pipeline capacity to its non-regulated affiliate PESCO. If it desires, Chesapeake may continue to sell its excess pipeline capacity to its affiliate PESCO at 17 cents per Dth like it does now or whatever rate it wants.

88. FERC does not allow State-required restrictions on access to released capacity which are unduly discriminatory or anti-competitive. (See Georgia Public Service Commission, 107 FERC ¶61,024, Docket No. RP04-92-000, Order on Petition for Declaratory Order, issued April 15, 2004, p.9) In Georgia Public Service Commission, FERC provided suggestions for revising the plan in that case to avoid conflicts FERC's rules and offered to provide similar guidance to other state regulatory agencies to facilitate state retail unbundling programs.[20] Chesapeake suggests that "[i]f the Delaware Public Service Commission wants to seek FERC guidance on whether requiring Chesapeake to apply asymmetric pricing principles to temporary capacity releases to PESCO would conflict with the FERC's capacity release rules, the Commission can seek a declaratory order from FERC…." Despite rejecting the Hearing Examiner's initial Recommendation in this Docket that Staff obtain a "No-Action" letter from FERC's Staff regarding

[20] FERC's recent amendments to its capacity release rules, issued in Order No. 712 (see Paragraph 83, supra), made several rule changes to accommodate state-mandated retail unbundling programs and asset management arrangements which facilitate such programs. The legal issues in this Docket may be worthy of a FERC amendment.

that issue, Chesapeake has not, to date, pursued a Petition for Declaratory Order before FERC which it is free to do. (*See* Company's Opening Brief at p.16.)

89. Instead of pursuing a Petition for Declaratory Order from FERC, Chesapeake's approach has been to forewarn that the Delaware Public Service Commission "could be exposed to potential sanctions, civil penalties and disgorgement orders" if the Commission orders that Delaware ratepayers be charged only at cost. Chesapeake cautions that FERC has recently become "increasingly aggressive in enforcing its capacity release rules." (*See* Company's Brief at pp. 16-17.) Chesapeake relies upon three (3) FERC cases as evidence of such recent FERC enforcement: In re Constellation Energy, 122 FERC ¶61,220, 2008 FERC LEXIS 487 (March 11, 2008); BP Energy Company, 121 FERC ¶61,088, 2007 FERC LEXIS 1937(October 25, 2007), and Bangor Gas Company, 118 FERC ¶61,186, 2007 FERC LEXIS 404(March 7, 2007) (2007). Chesapeake refers to the large penalties assessed against those companies and notes that the sanctions and penalties would have been more severe if the companies had not reported the violations themselves. (*See* Company's Opening Brief at pp.16-17.)

90. The Hearing Examiner is not persuaded by Chesapeake's arguments as to potential FERC-imposed penalties based upon the authorities relied upon by Chesapeake. In each FERC case above which Chesapeake relies upon, the company penalized by FERC had engaged in substantial, prolonged violations of FERC's "flipping,'[21] "shipper must have title,"[22] and buy-sell[23]

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[21] "Flipping" involves a series of repeated short-term releases of discounted rate capacity to two or more affiliated replacement shippers on an alternating monthly basis to avoid FERC competitive bidding requirements for discounted long-term capacity releases. *Constellation Energy, supra* at **4.

[22] Under FERC regulations, all shippers must have title to the gas at the time the gas is tendered to the pipeline or storage transporter and while it is being transported or held in storage by the transporter.

regulations. (*See* Staff's Answering Brief, pp. 17-18.) As Staff argues, the substantial penalties assessed against these companies are not surprising given the substantial, prolonged violations. (*Id.*)

91. In *Constellation Energy,* the company flipped capacity between affiliates for over 19 months; committed thousands of violations of the "shipper must have title" regulations; and engaged in two prohibited affiliated buy-sell transactions. As a result, *Constellation Energy* was ordered to disgorge $1.9 million in capacity release revenue and was also fined $5 Million. *BP Energy* arranged for released capacity to be flipped between two affiliates on an alternating basis for nearly two years; committed thousands of violations of the "shipper must have title" regulations; and engaged in two prohibited buy-sell transactions during 2005-06. Thus, *BP Energy* was assessed a civil penalty of $7 million for self-reported violations. *Bangor Gas* violated the "shipper must have title" regulations continuously over a period of six (6) years (2000-06). Thus, *Bangor Gas* was issued a civil penalty of $1 million. Chesapeake briefed no legal authority showing that FERC has ever assessed penalties, sanctions or ordered disgorgement against a shipper that was adhering to a state commission's directive that ultimately was

[23] Prohibited buy-sell transactions occur when a shipper holding interstate pipeline capacity buys gas at the direction of, on behalf of, or directly from, another entity (e.g., and end user), ships that gas through its interstate pipeline capacity, and then resells an equivalent quantity of gas to the downstream entity at the delivery point. Prohibiting such transactions allows FERC to prevent a capacity holder with priority to pipeline capacity from acting as a broker of transportation capacity or assigning transportation capacity to end users. *Constellation Energy, supra* at **8-**9.

found to be within FERC's sole purview. (*See* Staff's Answering Brief, p.13 fn. 7; *see also* FERC's "Statement of Administrative Policy Regarding The Process For Assessing Civil Penalties," December 21, 2006).

92. Finally, as Staff argues in its Answering Brief, should the Commission order that asymmetrical pricing principles apply here, the Company may request that the Commission grant a stay of the implementation of its Order pending further review at FERC on a Petition for Declaratory Order or on appeal to a court of competent jurisdiction. (*See* Staff's Answering Brief, p.18.; Paragraph 24 of 2001 Settlement Agreement.) I recommend that the stay be granted according to the terms in the following paragraph.

V. <u>RECOMMENDATIONS.</u>

93. For the reasons discussed above, the Hearing Officer's makes the following five (5) recommendations to the Commission: **1)** Chesapeake's practice violates the Commission's Order in PSC Docket 00-523 and 26 *Del. C* § 303(a). Chesapeake has not met its burden of proof as required by 26 *Del. C* § 307; **2)** because the Settlement Agreement in PSC Docket 07-246F does not support PSC Docket 00-523 and 26 *Del. C.* § 303(a), the Commission should not follow PSC 07-246's Settlement Agreement as it relates to Chesapeake's practice; **3)** Chesapeake should be required to credit Delaware ratepayers in its next GSR proceeding, the difference between the amount PESCO paid to Chesapeake for capacity release charges involving sales to PESCO's off-system sales customers and

the amount Chesapeake charged to Delaware ratepayers for the same capacity releases, plus interest as permitted by 26 *Del. C* § 311, for the period of January, 2008 through the date of the Commission's Order; **4)** if the Commission follows the Hearing Examiner's recommendations above, and if Chesapeake requests that the Commission stay the implementation of the Commission's Order pending further review at FERC or on appeal to a court of competent jurisdiction, the Commission should grant a stay of the Commission's Order, with interest accruing while the stay is pending; and **5)** the Commission should Order that Chesapeake hereinafter strictly adhere to asymmetrical pricing principles regarding all future off-system sales by PESCO.

94. A proposed Order, which will implement the foregoing recommendations, is attached hereto as Attachment "A."

Mark Lawrence

Hearing Examiner

Dated: January 7, 2010

A T T A C H M E N T "A"

BEFORE THE PUBLIC SERVICE COMMISSION

OF THE STATE OF DELAWARE

IN THE MATTER OF THE APPLICATION OF CHESAPEAKE UTILITIES CORPORATION FOR APPROVAL OF A CHANGE IN ITS GAS SALES SERVICE RATES ("GSR") TO BE EFFECTIVE NOVEMBER 1, 2008 (FILED SEPTEMBER 2, 2008 AND AMENDED JANUARY 8, 2009)	PSC DOCKET NO. 08-269F (PHASE II)

ORDER NO.

AND NOW, this_______ day of ____________, 2010:

WHEREAS, the Commission has received and considered the Findings and Recommendations of the Hearing Examiner issued in the above-captioned docket, which was submitted after a duly-noticed public evidentiary hearing, and which is attached to the original hereof as Attachment "A".

AND WHEREAS, on July 7, 2009, the Commission entered Order No. 7607 approving the Gas Sales Services Rates ("GSR") proposed by Chesapeake Utilities Corporation ("Chesapeake") in its September 2, 2008 Application and January 8, 2009 Supplemental Application for service rendered on and after November 1, 2008;

AND WHEREAS, in Order No. 7607, the Commission approved interim rates effective November 1, 2008 and more recent rates effective February 1, 2009;

AND WHEREAS, in Order No. 7607, the Commission authorized Phase II of this Docket addressing the amount to be credited to the Gas Cost Rate for pipeline capacity released to Chesapeake's subsidiary Eastern Shore Natural Gas and to serve the off-system customers of Chesapeake's subsidiary, PESCO.

NOW, THEREFORE, IT IS HEREBY ORDERED BY THE AFFIRMATIVE VOTE OF NOT FEWER THAN THREE COMMISSIONERS:

1. That, by and in accordance with the affirmative vote of a majority of the Commissioners, the Commission hereby adopts the Findings and Recommendations of the Hearing Examiner, appended to the original hereof as Attachment "A".

2. Chesapeake is required to credit Delaware ratepayers in its next GSR proceeding, the difference between the amount PESCO paid to Chesapeake for capacity release charges involving sales to PESCO's off-system customers and the amount Chesapeake charged to Delaware ratepayers for the same capacity releases, plus interest as permitted by 26 *Del. C* § 311, for the period of January, 2008 through the date of the Commission's Order.

3. Chesapeake is hereinafter required to strictly adhere to the asymmetrical pricing principles regarding all future off-system sales by PESCO.

4. That the Commission reserves the jurisdiction and authority to enter such further Orders in this matter as may be deemed necessary or proper.

BY ORDER OF THE COMMISSION:

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Chair

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Commissioner

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Commissioner

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Commissioner

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Commissioner

ATTEST:

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Secretary